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PP RUEHLMC
DE RUEHUM #0870/01 3480824
ZNR UUUUU ZZH
P 140824Z DEC 06
FM AMEMBASSY ULAANBAATAR
TO RUEHC/SECSTATE WASHDC PRIORITY 0596
INFO RUEHMO/AMEMBASSY MOSCOW 1637
RUEHBJ/AMEMBASSY BEIJING 5323
RUEHUL/AMEMBASSY SEOUL 2550
RUEHKO/AMEMBASSY TOKYO 2308
RUEHOT/AMEMBASSY OTTAWA 0363
RUEATRS/DEPT OF TREASURY WASHDC
RUCPODC/USDOC WASHDC 1134
RUEHLMC/MILLENNIUM CHALLENGE CORP WASHINGTON DC 0414

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SUBJECT: Mongolia's New Mining Law: Many Concerns

REF: Ulaanbaatar 832

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Summary and Comment

11. (SBU) Mongolia's new mining severely disrupts an industry that will and must be Mongolia's economic engine for many years to come. Most worrisome to miners are new provisions for the government to take equity stakes in a long list of "strategic" mines, provisions that leave unclear how much the state will pay for what it might take -- or even whether the state will pay anything at all. Other provisions grant considerable discretion to authorities under murky guidelines, a combination fostering corruption and arbitrary regulation. Foreign miners already cite early evidence of these problems. However, the news isn't all bad: tax changes were welcomed, and miners can live with other amendments. This detailed report on Mongolia's new mining law is meant to act as a resource for USG agencies involved with formulating and executing aspects of the US-Mongolia bilateral trade relationship. End summary and comment.

Strategic minerals and GOM participation

12. (U) Under amendments passed by Mongolia's parliament in July, the most important change from the 1997 Minerals Law of Mongolia is the creation of the concept of a "strategically important deposit" in which the Government of Mongolia has the right to obtain up to a 50% share of any mine. The amended law, Article 4.1.11, defines "mineral deposit of strategic importance" as "a mineral concentration where it is possible to maintain production that has a potential impact on national security, economic and social development of the country at national and regional levels or deposits which are producing or have potential of producing above 5% of total GDP per year." Ultimately, the power to determine what is or is not a strategic deposit is ultimately vested in the State Great Hural (SGH) (see Article 8.1.4).

13. (U) Article 5.1-5.6 describes state-ownership. If a mineral deposit is determined to be strategic, the GOM may claim: up to 50% if the state has contributed to the exploration of the deposit at some point (Note: this means exploration conducted during the socialist era primarily by Soviet geologists); or up to 34% if the deposit was developed with private funds.

14. (U) State participation (or share) "shall be determined by an agreement on exploitation of the deposit considering the amount of investment made the state; or, in the case of a privately-explored strategic deposit, by agreement between the state and the firm on the amount invested by the state.

15. (U) Article 8.1.7 states that the SGH may determine the state share using a proposal made by the government (executive branch) or on its own initiative using official figures on minerals reserves in the integrated state registry.

16. (U) Article 9.1.1-8 lists the GOM's powers regarding state ownership. It provides a list of strategic deposits to the SGH for approval; proposes how much the state might claim on such strategic deposits; and "resolves matters concerning the investment of Mongolia for a joint venture to develop a deposit of strategic importance."

(Note: The 1997 law had no concept of "strategic deposits" or state equity in mines.)

Comment on State Equity Provisions

17. (SBU) It is not explicit in the statute that the state will pay for its equity share, though many MPs tell us that was their intent. Across the board, western miners have made clear that while other provisions of the law might be onerous and corruption prone, state expropriation would drive them away for years to come. It also is unclear that the state would pay what the industry would regard as a fair value. Current best practice places a value on in-ground economically recoverable resources at no more than 10% of the total mine's value (This is what royalties pay for). Based on our talks

ULAANBAATA 00000870 002 OF 008

with the MPs responsible for this law, we believe they conceive of the GOM's contribution of an in situ deposit as if it were smelted and ready for industrial purposes, rather than as raw ore that needs a whole lot of investment to get it to market -- gold bullion versus gold ore, which needs quite a lot of work and investment to turn into ingots.

18. (SBU) As set out in the new law, "strategic" is so open-ended that any deposit might fit the definition. The GOM has submitted a list of forty-nine deposits it claims as strategic; but it remains unclear why these forty-nine were chosen, because most of them have not been thoroughly explored and all lack basic infrastructure. Government sources tell us they used a weighted scale that ascribe points to determine each deposit's economic, social, cultural, environmental, and regional impacts on Mongolia. However, no one outside the government has apparently seen the criteria, nor has the government allowed stakeholders to officially vet this process.

19. (SBU) GOM claims that the process was free of political interference are difficult to believe. For example, Boroo Gold Mongolia reported to emboff that politically influential MP and business man Su. Batbold (the former Minister of Industry and Trade until January) told them that their new gold mining project was on the "strategic deposit" list, but that it could be removed if they thought its presence would halt their negotiations with the government on revising their tax status on current projects. They agreed and their follow-on project was removed from an earlier list.

Exploration License Timelines and Local Approval

110. (U) Article 19 lays out an elaborate process for getting an exploration license. Under it, the Mineral Resources and Petroleum Authority of Mongolia (MRPAM) has 20 working days to issue its approval, followed by a 30 working day approval process for the Aimag governor to approve or disapprove of the exploration rights. There are two working weeks for MRPAM and two working weeks for the provincial governor to comment on the license. In total, the new system will take up to two months. (Note: By contrast, the old process required and allowed for no more than 20 business days.)

Tender Process for Some Exploration Rights

¶11. (U) In article 18.2.5, the law lays out a new procedure for obtaining exploration rights on land explored with state funds or lands where the current holder has forfeited exploration rights. MRPAM will tender such exploration rights only to firms technically qualified to conduct minerals work. The new tender procedure neither requires nor allows for a cash-bid. Only the technical merits of the exploration proposal are now supposed to determine who wins exploration rights. The MRPAM staff will have the authority and responsibility to assess the merits of proposals to determine who wins the tenders. (Note: The old law awarded exploration rights on a "first come, first served" basis, a process that gave little discretion to government officials to intervene.)

Comment on the new tender process

¶12. (SBU) The SGH had long been offended that so many tenements were licensed to people, mostly Mongolians, who did no exploring. MPs complained to us that that all these people were mere speculators intent only on selling their rights to Westerners, Russians, Chinese, etc., who would then explore after spending hundreds of thousands or even millions of dollars on choice sites. The SGH thought exploration and mining would be more likely to occur if licenses went only to mining experts. However, no evidence from any other mining nation proves that this type of limitation produces more mining.

¶13. (SBU) The older system, by providing a financial incentive through sale of tenements, motivated thousands of Mongolians into the mining game to make money by promoting thousands of tenements to firms able to mine or more thoroughly explore them. The most obvious victims of the new law are these same Mongolian citizens who once profited by speculating on tenements, but are now barred from entry. Ironically, the state is also a victim, because fewer tenements will now be presented to well-funded exploration firms.

ULAANBAATA 00000870 003 OF 008

The winners are those well financed private western concerns and Chinese and Russian state-owned firms able to pay for the expertise required under the new law.

¶14. (SBU) The other winners are the MRPAM and Ministry of Industry and Trade bureaucrats, who now have broad discretionary authority to select who will and will not get tenements. This new authority disturbs miners, who fear this power will be the source of corruption and arbitrary decisions by MRPAM. Evidence suggests that local mining guilds will define an expert in Mongolian mining as a person who received a degree from a Mongolian institution, such as the National University, rather than an internationally recognized institution. While this enforced employment program for Mongolian geologists would be an annoyance, the discretionary power MRPAM now has is most worrisome. If the MRPAM rejects experts and mining plan as un-qualified, no recourse is spelled out under the new law.

¶15. (SBU) Industry sources report that MRPAM is already interpreting its discretion over expertise broadly. MRPAM is telling firms that it will "take into consideration" companies' past exploration activities when it comes time to transfer licenses from the 1997 format to the new law's license format. The new law sets out a procedure in which only the completeness of the application and the qualification of the company's technical staff determine if the license will be granted, extended, or transfer from the 97 format to new regime. Nothing in the new law provides regulatory or statutory justification for revoking current rights based on past behaviour that was in accordance with the old law. Miners criticize the arbitrary, improper use to the new law to "expropriate" their rights.

¶16. (SBU) Finally, the law has the potential to limit the ability of rights holders to seek financing, because it forbids transfer of licenses and exploration rights to non-qualified individuals. Consequently, a miner will not be able to offer his licenses as

secured collateral to banks or to any lender lacking the professional qualifications to receive these rights if the miner defaulted on his debt obligations. MPs to whom this implication has been pointed out have expressed surprise.

"Exclusive" Removed from Exploration Rights Article

¶17. (U) In Article 21.1.1, the SGH removed the Mongol word "ontsgoi," which means exclusive in this context, from the new article. The old article read, "To conduct exclusive exploration for minerals within the boundaries of an exploration area in accordance with this law." The new article reads, "To conduct exploration for minerals. . . ."

Comment on Removing "Exclusive"

¶18. (SBU) It is unclear what, if anything, this deletion means. However, the deletion would seem to allow the government to apportion mineral rights per metal or mineral rather than as a whole, which has been the standard practice. Sources tell us that the SGH Speaker Nyamdorj deleted the word from the final draft after it had been re-inserted by other MPs, a fact that increases the likelihood the deletion is meant to be significant.

Pre-mining Agreement, Exploration Timelines, Fees

¶19. (U) Article 22 now allows for exploration rights to be extended up to nine years. The first period is three years, followed by two possible extensions (subject to MRPAM approval) of up three years each. (Note: The old law allowed only 7 years for exploration, after which the firm had to move to mining or give up the claim.)

¶20. (U) Article 23 allows for a pre-mining license period of three years. This recognizes that nine years may not be enough to go from exploration into feasibility and then production on some major projects. Granting of a pre-mining license requires the miner to go into commercial production no later than three years after the end of the exploration license.

¶21. (U) Exploration fees (Article 32) have risen:
-- 1st year goes from US \$.05 to US \$.10 per hectare
-- 2nd year goes from US \$.10 to .20 per hectare

ULAANBAATA 00000870 004 OF 008

-- 3rd year goes from US \$.10 to .30 per hectare
-- 4th-6th years rise from US \$.10 to US \$1.00 per hectare.
-- 7th-9th years are US \$1.50 per hectare

¶22. (U) Article 33 imposes a new work performance requirement on all exploration right's holders that rises each year and is subject to annual verification by MRPAM. Miners must submit annual report to MRPAM, and MRPAM will have the power and right to inspect the exploration site to verify that work is being done:

-- 2nd and 3rd years miners must spend no less than US \$.50 per hectare on exploration
-- 4th to 6th years miners must spend no less than US \$1.00 per hectare on exploration
-- 7th to 9th years miners must spend no less than US \$1.50 per hectare on exploration

Comment on new timelines and work requirements

¶23. (SBU) Miners approve the new longer exploration license period and the pre-mining period, because it gives them more time to conduct required feasibility and development work to bring complicated mines into operation. There is some concern about the time-frame between the expiration or cessation of the exploration license and the conversion to a pre-mining license. Nor are the miners comfortable with the lack of clarity regarding how one enters such an agreement with the GOM.

¶24. (SBU) Miners grumble about the fee increases but accept them. They presume that under normal circumstances they would return unpromising areas each year to keep total costs down. So the GOM and SGH's aim to get land into real exploration may be served, although this aim could have been achieved by simply raising fees and imposing work requirements through regulation rather than by a new law. There is some concern that the MRPAM lacks the capacity to verify work requirements. MP Oyun noted that this lack of capacity was the reason for not including this provision in the 1997 law, and that neither she nor others think MRPAM has increased its ability to monitor work plans since 1997. We agree with this assessment and share miners' fears that this requirement will turn into another rent-seeking opportunity for MRPAM staff.

Higher mining license fees and investment agreements

¶25. (U) Mining license fees increase for most metals and minerals (copper, gold, silver, fluorspar) depending on the metal; the fee is now US \$15 per hectare. Coal and other common metals (lead) are raised to US \$5 per hectare fee.

¶26. (U) Article 29 provides for the crafting of a long term investment agreement between the GOM and the mining firm. The base of this agreement is the amount to be invested. These rules apply to all actors in the mining sector.

-- If the investment for the first five years is between US \$50-100 million, the state can negotiate a 10-year investment agreement
-- If the investment for the first five years is between US \$100-300 million, the state can negotiate a 15-year investment agreement.
-- If the investment for the first five years is over US \$300 million, the state can negotiate a 30-year investment agreement

(Note: Under the old law, companies which invested \$15 million could conclude a "stability agreement" which exempted them from profit taxation for 5 years. The only Western firm to take advantage of this was Boroo Gold, whose 5-year tax free period has one more year to run.)

¶27. (U) The Ministries of Finance, Trade and Industry, and Environment shall collectively negotiate agreements between the GOM and the mining firm. These agreements will list the conditions that a firm needs to provide a stable business environment for mining over the term of the agreement. This includes: regimes for taxation; sale of products; income disposal; term of agreement; environmental responsibilities; social and industrial impacts; and benefits to accrue from mining activity, etc.

¶28. (U) The license holder must submit a feasibility study and investment plans to MRPAM, which submits them to the responsible

ULAANBAATA 00000870 005 OF 008

ministries. These ministries have three months to review the proposal, send it around the GOM for comments and clarifications and send a counter response to the industry. An additional three months is allowed for responses, making the process three months in total. Mongol Bank is listed as the prime repository of all such agreements.

Comment on investment agreements

¶29. (SBU) Most miners argue that the GOM's six month timeline for striking a deal is too ambitious given the GOM's lack of experience and capacity. The Ministry of Finance is already hard-pressed by the need to negotiate several agreements with China and Russia, not to mention the long-delayed Millennium Challenge Account proposals -- and now it must embark on negotiating at least two multi-billion dollar mining deals (the Ivanhoe/Rio Tinto Oyu Tolgoi copper mine, and the Tavan Tolgoi coal mine). Doubts about ministerial capacity aside, miners want to know if a mining operation can renew or renegotiate its investment agreement upon expiration of the initial agreement. Miners are not pleased that fees have risen and that new, undefined burdens have been imposed, but believe that they can deal with them.

Environmental Protection key requirement for mining

130. (U) Article 2 makes environmental protection a key part of the mining legislation. The new law also makes the mining law and environmental provisions listed elsewhere consistent with one another. Articles 39 and 38 explicitly require miners to submit environmental protection before licenses issuance. In addition, the GOM requires that firms to deposit half of the funds for each mine's annual reclamation budget in a bank account in the soum (county) where the mining activity occurs. Failure to deposit funds or fulfill environmental obligations can result in license revocation. Local authorities are apparently given wide discretion, along with the Ministry of Nature and Environment (MNE) and the State Special Inspection Agency (SSIA) to assess firms' compliance with regulations and statutes. Failure to comply can result in revocation or suspension of licenses and mining rights. The law does allow the licensee to go to court against such decisions, but the license will be suspended or revoked during that period. (Note: There were environmental requirements in the old law, but they did not occupy the key position they do in the new law.)

Comment on environmental provisions

131. (SBU) SGH Speaker Nyamdorj pushed the environmental aspect of the new law quite aggressively, making extremely emotional appeals about stopping the rape of Mongolian land by miners who consistently ignore environmental provisions. However, these ambitious provisions are not matched by any training or support to localities and agencies expected to enforce the law. It is not part of this law, but the law on environmental impact assessments requires that they be done by Mongolian experts, certified locally, who ironically enough do not meet the MNE environmental standards on mining activities. The power to revoke and suspend are likely sources of corruption, giving officials the opportunity to blackmail miners.

New local employment requirements

132. (U) Article 43.1 states that license holders cannot employ more than 10% foreign workers. If they do exceed the 10% limit, they will incur a monthly penalty of 10 times the minimum monthly salary as specified in Mongolia law. Fines are to be paid monthly to local governments for distribution into education and health sectors. (Note: This provision is not inconsistent with current labor law regarding foreign employees, but was not in the old minerals law. The payment of the fee to the locality is new, and the new fee will be about \$600, versus \$80 currently.)

Comment on employment requirements

133. (SBU) Western firms do not have anything against this, as they prefer to use Mongolians, who usually cost less than expatriate employees. This provision is probably aimed at Chinese, Mongolian,

ULAANBAATA 00000870 006 OF 008

and Russian firms that would use cheap foreign labor to lower their respective costs.

Royalty Rates, Distribution of Revenues to Localities

134. (U) Article 47.3.1-2 sets the following rates for royalties in Mongolia.

-- Royalties for Domestically sold coal for energy and common mineral resources shall equal 2.5% of the sales value of all products extracted from the mining claim that sold, shipped for sale, or used.

-- Royalties for all other extracted products (excluding coal) shall equal 5% of the sales value of all products extracted from the mining claim that sold, shipped for sale, or used.

135. (U) Article 59 specifies that licensing fees shall be deposited in the budgets of the provincial capital, soum, and district where the activity is taking place, as well as the central budget.

- 25% to the soum
- 25% to province
- 50% to the central budget

136. (U) Royalties payments are distributed as follows:

- 10% to the soum or district
- 20% to the province
- 70% to the central budget

(Note: Coal royalties remain the same, but rates for all other products rise. Under the old law, the central government took all revenues.)

Comment on new royalty provisions

137. (SBU) Miners grumble about the higher rates, but accept that the 5% rate is about mid-range for most jurisdictions. More important is the distribution of revenue to the provinces. On its face, we and other stakeholders agree that a guarantee that the countryside will see some monies from mining activities that occur within their jurisdictions is a positive step. However, the presence of the article in the mining law may have no legal force on allocations from the state budget, as the Ministry of Finance may be able to ignore a provision not appearing in the law on state budget, which controls allocation of state funds. If revenues do flow to the localities, local administrations are ill equipped to administer what in some areas may be huge revenue streams.

New public reporting requirements

138. (U) Articles 48.9 and 48.10 impose the following reporting requirements on royalties and sales on mining firms.

- A license holder must prepare a quarterly report in a form approved by the tax office accounting for the sum of each quarter's royalties and an annual report for the entire year's royalties, also for submission to the relevant tax office.
- A license holder shall annually report to the public the amount of their product sales for that year and the amount of taxes and payments paid to the central and local budgets.

(Note: The old law required no public disclosure of tax receipts, royalty payments, and sales data.)

New tax provisions

139. (U) Articles 61.4, 61.5, and 61.6 discuss revised tax provisions.

- Article 61.4 states that a loss incurred in any tax year may be deducted from taxable income during the 2 tax years following the year in which loss was incurred.
- Article 61.5 states that costs incurred in developing industrial and social infrastructure shall be depreciated on a straight-line basis over the useful lives of the facilities constructed. All

ULAANBAATA 00000870 007 OF 008

costs of maintaining and operating such infrastructure facilities shall be expensed in that particular year.

--Article 61.6 states that costs of absolutely necessary maintenance incurred in connection with mining operations shall be included in the operating costs

(Note: These tax provisions were essentially in the old law; however, the Tax Authority of Mongolia routinely ignored them because they were not in the implementing tax legislation. New tax legislation passed last summer has these mining tax provisions.)

Comment on new tax provisions

¶39. (SBU) Miners are very pleased with these changes, although they would have preferred even more generous provisions in view of high costs and long development lead times. The previous terrible tax situation was one major impetus behind tax holidays in stability agreements; in turn, such holidays proved a political albatross for foreign mining companies, feeding into the argument Mongolians did not receive their due from the companies' profits.

Restrictions, Burdens on License Transfer, Pledging

¶40. (U) Article 49 describes the increased documentation required to transfer a license. For instance, the documentation must show that both environmental protection and professional qualifications concerns are being accounted for. The phrasing grants authority to MRPAM's Chair to refuse a transfer even it complies with the state requirements.

¶41. (U) Article 52 makes clear that a license-exploration or otherwise-can only be pledged to a transferee eligible to hold such a license.

Comment on increased restrictions on license transfer

¶42. (SBU) As with exploration rights, these new requirements to hold a license imperil the security and transferability of mineral rights. Strictly read, a holder of rights could not pledge those rights as an asset to a bank or other investor who otherwise was not eligible to hold a license. A given bank is unlikely to set up a "qualified" mining firm just to receive a pledged license offered as collateral. At a stroke the law limits the investment pool that a mining firm might tap to finance its mine.

¶43. (SBU) Mining firms also are very wary of the authority granted to the MRPAM to approve transfers of existing licenses. Although Ivanhoe has complied with all the new requirements, MRPAM has refused to shift Ivanhoe's coal assets from its copper mining company to a new entity dedicated to coal mining exclusively. Ivanhoe is now murmuring about international legal action to fight what it views as expropriation.

Reimbursement for state funded exploration costs

¶44. (U) Article 60 requires mining firms to reimburse the state for costs incurred to explore deposits on tenements. These expenses are booked and documented in the State integrated registration. Miners are to strike repayment agreements with set schedules for repayments prior to commencement of formal mining operations. If the State is not reimbursed, failure to do so will incur a 0.1 % penalty per day on the total amount. If after 30 days payment of fines and the principle is not completed, the mining license holder will have his rights revoked and the holding tendered by bid. (Note: The old law also contained this provision but without the penalties imposed in the new law.)

Comment on reimbursement of state exploration cost

¶45. (SBU) This requirement has always irritated miners. Most countries perform such services gratis or with a nominal fee; or they do not conduct such explorations at all, seeing this activity as more suitable to private enterprise. The GOM is still having trouble extracting itself from functions best left to private firms.

ULAANBAATA 00000870 008 OF 008

Its soviet-era geology in no way matches the current state of the art, and it is somewhat galling to miners to have to reimburse the GOM for work that does not really determine the nature and quality of a given deposit

